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The relations of federal, state and local revenues

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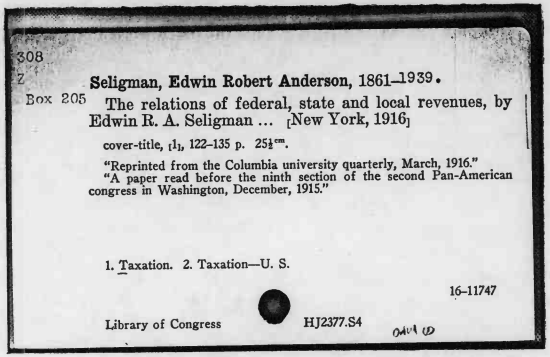

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THE RELATIONS OF FEDERAL, STATE AND LOCAL REVENUES

By
Edwin R. A. Seligman

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THE RELATIONS OF FEDERAL, STATE AND LOCAL REVENUES*

I.

IT is only in modern times that the fiscal inter-relations between central and local governments have become of importance. In ordinary states the question is one of divergence between national revenues and local revenues. In federal states the problem is further complicated by the interposition of the commonwealth or state between the federal or national government on the one hand and the local government on the other.

Government revenues are the counterpart of government expenditures, and these depend primarily upon the character and the extent of government functions. From this point of view, the fiscal relations in question are of considerable complexity. All expenditures were originally local in character. Economic life was at the outset based upon a local economy, and what little money was spent was both raised and expended primarily for local purposes. It was only when the national state developed as a result of the profound economic changes of the later middle ages that national expenditures now appeared on the scene, and especially for the purposes of the army and the navy. Somewhat later there came a two-fold development as a consequence on the one hand of trade and commerce and on the other of democracy.

Trade and commerce were responsible for the growth of expenditures connected with transportation, and especially with good roads. Although this was accomplished in part by the localities, more and more supervision was exercised by the central governments, so that the expenditures of the central government for such purposes now grew to considerable proportions. The same was true still later when, as in France, the construction of canals called for large outlays. The result of the movement down to the beginning of the nineteenth century was that the great burden of expenditure resting upon the individual was primarily for the purposes of the central government, and that even in England the local expenditures were limited in large measure to the care of the poor, with very slight additions for roads and other miscellaneous purposes.

* A paper read before the Ninth Section of the Second Pan-American Congress in Washington, December, 1915.

At the beginning of the nineteenth century, the democratic movement, which was the result of the industrial revolution, altered the situation in two ways. In the first place, there now came a rapid increase of expenditures for education, for improving the health and sanitation of the community and, finally, for developing the general welfare in its still wider aspects. In the second place, these expenditures were overwhelmingly local in character, although there has also been a tendency of late for the central governments to assume to an increasing extent some of the same functions. The consequence has been that, on the whole, in the most recent period local expenditures have become in many ways quite as important as, even if not more important than, the central expenditures.

While there has been this general movement, the situation has been complicated by the fact that government functions and expenditures have been variously apportioned in different states. In some states certain functions have been gradually relegated to the local communities; in others, the contrary is the case.

In the Anglo-Saxon communities, there has been a growing tendency for a central control over the local functions of government; in others, as in France and Italy, there has been a tendency toward a greater decentralization. Moreover, in all federal states a further complication has been introduced in that in the separate commonwealths or states that stand between the localities and the federal government there has been a mixed movement both toward centralization and toward decentralization; so that in some communities the one tendency preponderates, in other communities the contrary. In the United States, for instance, the states have been gradually assuming the control of several functions that were originally left to the localities, as in the case of highroads, hospitals, asylums, state constabulary, and the like. On the other hand, the states have been losing some of their functions to the central govern-

ment, as in the case of the growing federal control over railroads and various forms of business enterprises; and we now hear insistent demands for a federal quarantine, and for federal control of labor conditions. As a consequence, there is at present no clear-cut line between federal, state and local functions and expenditures.

Since the revenues of government stand in a certain relation to expenditures, the same difficulties that have arisen in the case of expenditures reappear in that of revenues. In fact, there are even more complications in revenue than in expenditure because of the possibility, as we shall see, of expenditures by one form of government being defrayed out of the revenues derived in part or in whole from another form of government. The whole subject of public revenues is therefore bound up with the problem of a proper relation between central and local finance, or in the case of federal governments between federal, state and local finance.

II.

As a preliminary to a discussion of the fiscal relations of central and local governments, it is necessary to recall the two controlling principles of public revenues. These, as is well known, are, on the one hand, the principle of ability to pay and, on the other hand, that of benefit conferred. It need not be pointed out that the latter was the one long accepted by publicists, and it is only in recent times, with the emergence of modern democracy and with the insistence on the specifically social aspects of public finance, that the principle of ability to pay has come to the front. The most recent analysis of the subject, however, discloses the legitimacy of both principles, although it is careful to relegate each principle to its proper sphere. It is now well understood, for instance, that taxes in general must be framed and apportioned according to the principle of ability to pay; while most of the remaining categories of public revenues, such as fees, special assessments, and prices of all kinds for governmental services conform to the principle of benefits conferred or cost incurred.

While this demarcation is now generally accepted, it is none the less true that there is a certain border line or zone of indifference. Certain taxes like some imposts on land can be upheld almost

as well on the principle of benefits as on that of ability to pay; while other payments, like inheritance taxes, which in some countries (like the United States) are legally included under the head of payments made for benefits or privileges, correspond in reality to the principle of ability. Without attempting to pursue further this inviting line of inquiry, it is sufficient for our purpose to point out that there is a jurisdictional division corresponding roughly to the above division in principle; that is to say, the chief home of revenues predicated on the principle of benefit is to be found today in the local divisions, while the chief home of revenues based on the principle of ability to pay is to be found in the more central governmental jurisdictions. The line is, indeed, not entirely sharp; for we find, on the one hand, some fees levied and not a few industries or enterprises conducted by central governments; while, on the other hand, certain local taxes are to be explained primarily on the principle of ability to pay. But as a general principle it is true that there exists in most countries today a larger field for the principle of benefits in the localities, and a larger field for that of ability to pay in the central jurisdiction.

III.

If we turn to an analysis of the actual conditions to be found in the fiscal relations of central and local governments and if we confine our attention to what is the most important part of the subject, viz., the revenue from taxes and primarily from taxes which may be upheld on the principle of ability to pay, we shall see that there are no less than five different methods actually employed. These are as follows:

(A) The taxes are assessed by local authorities, with additions for the use of the central government. This is the common method in the American commonwealths, where the local revenues are derived, to an overwhelming extent, from the general property tax, levied upon real and personal property alike. The rate of the tax for purely local purposes is ordinarily arrived at by dividing the assessed valuation of the property in the locality by the amount to be raised for local purposes. To this local rate there are added rates for county as well as for state purposes, each of which is ascertained by dividing the assessed valuation of the property in the

locality by the amount needed for the expenses of the county and of the state respectively. The same tax, assessed by the local officials—*viz.*, the general property tax,—is thus utilized for both local and central purposes.

(B) The tax is assessed by the central authorities with additions for local purposes. This is the reverse of the system last mentioned. It is to be found in France, whose example has been copied in not a few states. In France there are four taxes levied for state purposes: the land and buildings tax, the *patentes* or business tax, the *personelle et mobilière* or personal tax, and finally the door and window tax. The local revenues are obtained by adding a certain percentage, known as the *centimes additionels*, to each of these state taxes. There are, indeed, other revenues, chiefly from indirect taxes for state purposes, and from the *octrois* for local purposes; but the fact remains that so far as the bulk of local revenues is concerned, they are derived from this simple addition to the direct state taxes.

(C) The separation of the sources of revenue; that is, certain taxes are utilized for central, and others for local purposes. This separation again is either total or partial. A partial separation is very common. Virtually all nations, for instance, reserve customs duties, whether import or export duties, for the central government. Many nations again reserve definite classes of indirect taxes for the central government. In the United States, for instance, there are only one or two exceptions to the general rule that the indirect taxes are devoted to federal purposes, in the shape of the Internal Revenue. The same is true, although to a somewhat slighter extent, of the German Empire. Even in regard to direct taxes, however, the principle of separation of source is not infrequently found. In Great Britain, for instance, the income tax is utilized for the nation, while the local revenues are derived almost exclusively from the local rates or real estate taxes. Again, in Germany, the so-called taxes on yield (*Ertrags-Steuern*), which correspond to the four direct taxes still levied in France, are, since the reforms of 1893–1895, reserved exclusively for the local governments, although for the sake of better administration they are still assessed by the states. In the United States this tendency is also

visible. In not a few commonwealths the inheritance tax and even the corporation taxes are now allocated to the state, while the local governments depend more and more upon the property tax. In New York this policy has been carried to such an extent that for a number of years during the first decade of the present century, it became unnecessary to levy any so-called direct or property tax as an addition to the local tax. In California this principle has been carried to the utmost limit, so that there is a complete separation of sources of revenue between the state and the localities.

(D) The division of the yield; that is, the revenues are collected by the central authorities, but a portion of the yield is assigned to the localities. This system, however, does not stand by itself alone; but it forms an incidental although important part of the revenue system in not a few countries. In the German Empire, for instance, the yield of the inheritance tax is divided between the empire and the states, and that of the land-increment taxes between the state and the localities. The same is true of the so-called death duties in Great Britain, where a portion of the yield is reserved for the local divisions. An analogous condition prevails in some of the American commonwealths where railroad or other corporation taxes are assessed and collected by the state governments, but are then returned in part to the local divisions. Conspicuous illustrations of a similar method are seen in New York in the liquor license or transfer tax and the mortgage tax, the proceeds of each being divided between the state and the locality.

(E) The system of subventions or payments from the central to the local governments or from the local to the central governments. A notable example of the former system is to be found in Canada, where, as a result of the surrender by the separate provinces of the right to levy customs and excise duties, the Dominion transfers annually large subventions to the provincial treasuries. A similar system is in force in Australia, since the constitutional amendment of 1910, as a result of which the Commonwealth, in return for the privilege of levying all customs and excise revenues, annually pays over to the separate states a fixed sum *per capita*. In all these cases the payments are made by the federal to the state government. In other

countries, however, the reverse system obtains. During the period of the first Constitution of the United States the Federal government was almost entirely supported by the so-called requisitions upon the states, and today the German empire is still very largely alimented by the so-called *Matricular-Beiträge,* or contributions made by the states.

In comparing these five systems, it is clear that the first and the last possess obvious disadvantages. One of the chief difficulties connected with the first system is that the utilization for general state purposes of a locally assessed tax on property inevitably leads to an under-assessment of the property. It makes little difference, for instance, whether for purely local purposes we have an under-assessment of property with a high rate, or a full assessment with a low rate. Since a definite amount of revenue is needed for local purposes, and therefore a definite amount of money must be taken out of the pockets of each individual, as long as the property of all individuals is assessed in the same proportion, it makes no difference whether we have a low or a high rate. As soon, however, as the assessment is utilized for state purposes, and the amount to be raised is made to depend upon the assessed valuation in the county or the locality, it is clear that the lower the local valuation, the less will be the aggregate amount which the locality will have to pay to the state. This is one of the chief causes which have led to the under-assessment of property in the American states, and it is largely for this reason that the movement is now so pronounced in the United States toward both a central supervision over local assessments and an abandonment of the local property tax for state purposes. The first method thus is clearly susceptible of improvement.

The fifth system, again, namely that of subventions, is only a makeshift. To have the Federal government depend entirely upon largesses from the states is to render it more or less impotent, and certainly to make it subordinate to the states. That was the result of the American system of requisitions, and is one of the reasons for the growing fiscal complexities of the German empire. On the other hand, to make the separate states depend financially upon the federal government is to weight the balance in the opposite

direction and is not, in the long run, desirable in the interest of a complete equilibrium. The system of subventions is concededly a makeshift system, and in Australia it has therefore been limited to a period of ten years.

The third system, namely that of the separation of source, possesses some advantages. The first is the conformity with the natural division of governmental functions and activities. Certain activities of government are local, some are inter-local or state, and some are national. If the revenues can be made to conform to this natural division, so much will be gained. The second advantage is the securing of greater equality in the assessment of property, and especially of real-estate, leading to the elimination of the unfortunate scramble for reduction of valuation in the localities. The third advantage, so far as concerns the relegation of the property tax to the localities, is a reduction to that extent of the direct taxation of property. The fourth is the removal of conflicts between the cities and the rural counties. The final advantage is the greater flexibility and adaptation of means to the end, whereby each locality may be better able to adjust its fiscal system to its own fiscal needs.

While these advantages are undoubted, we must be careful not to push the principle too far. As we have seen above, the line between local, state and federal functions of government is by no means always clear cut; and a complete separation of source might put into too bold a relief a division which does not exist in actual life. Moreover, a complete separation of source may sometimes introduce fiscal embarrassment. It may, for instance, happen that the particular source of revenue assigned to either the local, the state, or the federal government may be more than adequate for its purpose, while the source assigned to the other jurisdictions may be inadequate. There seems to be no convincing reason why the surplus of the one kind of revenue should not be utilized to make good the deficit of the other. Finally, it may occur that while a particular source of revenue is normally desirable for the local as against the state government, or for the state as against the federal government, it will none the less be found that there are certain aspects of that particular revenue which make a part of it, at least, preferable for the broader jurisdiction.

In short, while there is much to be said for the principle of separation of source, we conclude that it is in need of being supplemented by other principles in order to secure a well-rounded fiscal system.

We come, then, finally to the consideration of the second and the fourth systems, mentioned above as B. & D.

The system of a centrally assessed tax with additions for local purposes has much in its favor, especially when the tax chosen is one with a broad base. A good example of such a system is the Prussian income tax, which is administered by the state, and where additions up to a certain percentage are permitted for the use of the localities. The advantage is that the individual in paying his tax bill gives a lump sum for both state and local purposes, and is relieved from the annoyance of separate returns. The same is true of the *centimes additionels* in France. The obvious danger, however, in such a system is that by using the same tax for both state and local purposes we run the risk of increasing the rate to such an extent as to interfere with its maximum productivity,—a danger inherent in any system which looks toward the singleness rather than to the multiplicity of taxation. With this warning, however, and on the understanding that the system must not be pushed to an extreme, much may be said for the above method of local additions to centrally assessed taxes, as supplementary to the other methods in vogue.

Finally, we come to the principle of division of yield. This is the obvious result of any particular source of revenue where the stream of income gushes forth so abundantly as to produce more than is needed for the purpose in hand, and where, conversely, there is a deficiency elsewhere. An example of this is afforded by the railway taxes in some American commonwealths. It is conceded that from every point of view it is preferable to have the assessment of railways in the hands of central authorities; for the experience of the American states with the local assessment of what is essentially inter-local or extra-local in character has been unfortunate. To take, however, the entire revenue of railways for state purposes would be in not a few cases to rob the localities of a share of what they have been accustomed to rely upon; and it was, therefore, an

easy transition to introduce the system of a state assessment and collection, with a repartition of at least a part of the yield among the localities. The same point of view is observable in the German inheritance tax, where for administrative and fiscal reasons it was found desirable to levy the tax as a federal impost, but where the separate states which had been accustomed to depend upon that source of revenue were able to prefer a claim to a portion of the yield.

In short, wherever it can be shown that a particular tax might well, on the basis of general economic considerations, aliment both the central and the local treasuries, there is strong reason for maintaining the principle of division of yield.

Our general conclusion from the above analysis is that, while the first and fifth methods are relatively indefensible, a combination of the second, third and fourth methods affords a reasonable ground for expectation of success.

IV.

In deciding upon choice between, or a combination of, the above methods it is well to keep in mind certain fundamental principles. The three principles that should guide in the allocation of revenues as among various tax jurisdictions are: the extent of the base of the system, the efficiency of the administration, the adequacy of the revenue.

The extent of the base of taxation is obviously important. Some taxes rest, by their nature, upon the broadest possible base. The productivity of an inheritance tax for example depends upon the number and size of the assets of decedents. It is clear, however, that the smaller the area, the more variable will be the revenue. In a single town the death of one wealthy individual may swell the revenue from the inheritance tax in any one year to a point which may not be reached again for many years to come. This would be fatal to fiscal stability. A similar consideration would apply, although in a somewhat diminishing extent, as between state and nation in a federal government. The larger the area, the more regular the revenue.

Take, again, business or corporate activity, which originally was

local in character but which has now become state and even national in character. Where the base is so broad, any attempt to narrow the jurisdiction is fraught with peril. In the Middle Ages, for instance, a local or municipal tax on personal property was entirely feasible, because of the essentially local character of property. In modern times, however, the assets of a large business and the intangible character of much of the property have now become national or international in scope, so much so in fact as to render fruitless any attempt to reach that property by local methods; and the same consideration has led to the abandonment in recent years of any effort to levy a purely local income tax.

Secondly, the efficiency of the administration. Certain taxes like real estate taxes are specially adapted to initial local administration, because the assessment takes place under the eyes of the individual taxpayer. In many other cases, however, the farther away we get from local administration the better the chances not only of securing expert officials, removed from the dependence upon local prejudice, but also of making allowance for certain inevitable gaps in any local administration. When the administration, for instance, of the liquor license or excise tax in New York was transferred from local officials to the state administration, the revenue was largely increased. Again, if we have a system of state assessment of corporations, the difficulty arises not only as to the allocation of the due proportion of total revenues earned by the corporation, but also of knowing what to do with purely interstate revenues. In the case of the inheritance tax, where a part of the revenue has been based upon the principle of residence of the decedent, we cannot ignore the chance of evasion by transferring the legal residence to a state where the tax does not exist, or where the rates are lower. Finally, the history of the United States particularly has shown that a federal administration is often more efficient than the state administration. Compare, for instance, the results displayed in the construction of the Panama Canal with those shown in the construction and maintenance of the new highways in New York. The efficiency of central as over and against local administration depends not only upon general political and administrative conditions, but also upon the constitutional and economic relations of certain revenues themselves.

Thirdly, the adequacy of the revenue in question must not be overlooked. In a certain jurisdiction which is already fairly well supplied with revenues, and where for reasons of greater equality or expediency a new source of revenue is added, it not infrequently happens that the total is more than is needed, while, on the contrary, as again not seldom occurs, where this new source had previously been enjoyed by another jurisdiction, the situation may be the reverse. Take, for instance, the case of a tax on corporations, which up to that time had largely alimented the local budget and which now is transferred to the state, thus resulting in a possible deficit in the one case and a surplus in the other. Take, again, the much mooted project of a federal inheritance tax in the United States, where even if the income were needed, the gap in the revenues would be strongly felt by the separate states. Such examples, which might easily be multiplied, indicate the need of a careful consideration of the principle of relative adequacy of the revenues.

The practical inferences from the above would, of course, differ in every nation. I shall limit myself, in closing, to a summary of the conclusions applicable at the present time to the United States.

The federal government should rely largely upon customs duties and indirect taxes, to be supplemented by a federal income tax and a federal inheritance tax. Up to the last quarter of the nineteenth century, the federal government depended, except in a few emergencies, upon customs duties. During the Civil War a system of internal revenue was added, because it made possible changes in the customs duties which without them would have been far more difficult to bring about. A single source of taxation is always less elastic than a multiple source.

While from a purely fiscal point of view the customs duties and the indirect taxes would entirely suffice for the support of the federal government, there has been, during the past few years, in the United States as elsewhere, an irresistible demand to supplement this system of indirect taxes by direct taxes which would respond more clearly to the principle of individual ability to pay. This movement has resulted in the imposition of a federal income tax, and will probably lead to the enactment of a federal inheritance tax. It is, on the whole, defensible not only from the point of

view of equality of taxation, but also because both the income and the inheritance tax rest on so broad a base as to make their utilization by the federal government desirable. For a federal assessment will remove the difficulties of interstate taxation and minimize the dangers of jurisdictional evasion.

On the other hand, the scope of the federal direct taxes should not be exaggerated. While the modern tendency is everywhere in the direction of lessening indirect taxes, it must be remembered that the change is largely due to the fact that they have hitherto played an over-whelmingly preponderant rôle in taxation. It is a sound fiscal maxim not to rely exclusively or even to a preponderant extent upon either direct or indirect taxes, for each system has certain advantages of its own. In view of the fact that state and local taxes in the United States are to so very large an extent direct in character, it would seem to be the statesmanlike policy to retain a substantial measure of indirect taxes for the support of the federal government. The income tax and the inheritance tax which may be levied by the federal government ought, therefore, to be regarded as supplemental, rather than primary sources of income; especially as both the income and the inheritance taxes will be needed in the future to a still greater extent for purposes of state and local revenue. Our conclusion, therefore, is that the rate of the federal income tax ought to be relatively low; and that if a high inheritance tax should be imposed, only a portion of the yield ought to be retained for federal purposes.

The states, on the other hand, should rely chiefly upon corporation taxes, upon special taxes on property; and upon liquor and other license taxes. Where these do not suffice and an increasingly successful endeavor is made to abolish the inadequate general property tax, the states should rely, in addition, upon a part of the inheritance tax, to be assessed by the federal government, and finally upon income taxes, which should be supplementary, and as far as possible conformable, to the federal income tax.

The reason why a distinction is made in the suggested assessment of these two taxes is that the problem of residence is more easily solved in an income tax than it is in an inheritance tax; for the inheritance tax is really a tax upon the estate of a decedent,

while the income tax may be so arranged as to include a business tax as well as a tax upon the individual. In either case, however, and irrespective of the jurisdiction which assesses the particular tax, some American states will no doubt, to an increasing extent, rely upon both the income and the inheritance tax.

Finally, local governments should rely primarily upon revenues referable to the principle of benefits, such as special assessments and fees of all kinds, which should be better regulated by state law; upon the tax on real estate and especially upon land taxes; and, so far as further revenues are needed, as a substitute for the unworkable personal property tax, upon additions to the state income tax.

It is not unlikely that the problem of fiscal interrelations will be solved in this general direction in the United States; for the solution is in harmony with the fundamental principles that have been presented above. In other countries, the practical aspect of the solution will no doubt be different; but it is safe to say that throughout the world the trend of adjustment in the fiscal relations of federal, state and local governments will be found to be in line with the solution that has been sketched above.

EDWIN R. A. SELIGMAN

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